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DISTRIBUTION AND CHANGING CUSTOMER NEEDS

A Summary of Presentations at the 1986 Trends Conference[1/]

The theme of the 1986 Trends Conference was "Distribution and Changing Customer Needs." Deregulation, a change in customer behavior and new technologies have brought new competitors into the financial services business. These forces have changed the fundamental economics underlying the securities industry. This, in turn, has led to questions concerning current distribution techniques and experimenting with new ones.

This issue of Securities Industry Trends summarizes the conference speakers' remarks concerning distribution in the financial services industry.

1/ The full transcript of the 1986 Trends Conference is available for $75. An order form is enclosed.

STRATEGIC DISTRIBUTION

"The Role of Distribution in Meeting
Customer Needs -- and Making a Profit --
in Today's Financial Services Environment"

William T. Gregor
Anne Benedict
Management Analysis Center, Inc.

Distribution channels -- the mechanisms that deliver products to customers -- have undergone tremendous change in recent years, fueled by both deregulation and new technologies. Rule 415 has reduced the number of syndicate participants; and negotiated rates have led to increased institutional influence on pricing and service decisions and to substantially increased principal trading. Deregulated commissions have seen the rise of discount brokers as a significant force in the retail market. While these changes are occurring, new technologies are altering marketing, operations, and distribution costs. At the same time, customer needs are also evolving, with increasing demands for new kinds of service, product features, and distribution alternatives.

To respond to these forces, firms have developed a range of offerings that combine products of varying complexity with a number of different distribution channels designed to meet various customer needs. For example, commodity products like money market mutual funds do not require a great deal of added value through distribution; and consumers will buy them through the mail. Options trading, on the other hand, is a complex, customized offering for which customers demand -- and are willing to pay for -- personal service and expertise; in other words, high value-added.

Distribution in a Changing Environment

Distribution is more than just sales; it also plays an important role in customer maintenance, through transaction delivery, customer service and revenue collection. The new environment has changed both the kinds of distribution channels offered and the cost structure of the business and made distribution an element that must be managed. Distribution is costly, about 80 percent of total costs or revenues for a full service broker. In each of the three major sectors of the securities industry -- that is, in the underwriting and sale of primary issues, in secondary trading, and in retail distribution -- firms are finding new ways to remain competitive and profitable.

Distribution of Primary Issues

The initial stage of securities distribution is the underwriting and sale of primary offerings, and this business is dominated by so-called investment banks. Because of several

factors, these firms have seen few new entrants relative to other areas of the securities industry. Still, this market is changing, because Rule 415 has fostered increased competition and because customers are demanding more services.

The big players in this business have the capital, the customer base, the talent, and the prestige to compete for a wide range of customers and offer virtually any product; the trick is to determine which markets and products are truly profitable. For smaller entrants, a "niche-player" strategy is necessary: they must focus on the areas they can serve well and target distribution channels to deliver the products their customers want, within the limitation of their resources. Like the full-service firms, they must match their distribution benefits to the complexity of their products.

Distribution in Secondary Trading

In the ten years since commission rates were deregulated, the structure and nature of competition has changed significantly in the secondary trading sector. The institutionalization of the market has meant greater sophistication among investors and new competitive demands. Investment bankers and full-service firms that dominate the primary offering market are also players in the secondary market distribution channels, as are some niche players. Another set of competitors -- third party brokers -- have joined the secondary market in the last decade as well, and have developed pricing strategies that have driven down commissions throughout the industry.

Increased customer sophistication has led to a change in the approach to distribution. Commissions have come under scrutiny by institutional investors, who are demanding that rates reflect the value added by the broker/dealer rather than a flat per-share rate for all types of trades. Customers have also expressed dissatisfaction with research and other services. At the same time, customers are willing to invest in a broader range of instruments. These new demands on firms have turned the brokers of the 1970s into today's dealers.

Players in the secondary market, along with those in the retail market, have made some radical changes in their distribution channels, the most dramatic of these being the increased use of automation to improve distribution capabilities and reduce costs. New products, including financial futures, restricted stock sales, mortgage-backed securities, and high yield bonds, are yet another distribution innovation.

Distribution at the Retail Level

Competition -- from banks, insurance companies, and retailers, along with the forces of increasing customer sophistication and more new products -- has radically altered

this segment of the securities market. Even though institutional trading now dominates the market, individual investors' investments in mutual funds, equities, pension funds, government securities, and credit market instruments has increased dramatically: from $1.9 trillion in 1968 to $6.6 trillion in 1984.

As in other markets, customer needs have changed, too. Individual investors are more willing to try new products and experiment. They need a wide range of products, demand service, and vote with their feet. Responding to those demands has meant changes in the distribution channels in the retail sector -- the most complex distribution network in all the securities markets.

Where once the account executive and full-service firm was the norm, now they are only one of a number of channels: direct mail, telemarketing, electronic delivery are all vying for the same customer base. Each channel offers different value-added and has a different cost structure, giving rise to the most important challenges facing securities firms today. The cost of the traditional account executive is fast becoming prohibitive: the dollars spent on compensation and on housing the sales force represent nearly 60 percent of revenues. Changing that system is also expensive and account executives who feel threatened often leave, taking their clients with them.

ISSUER, INSTITUTIONAL AND INTERNATIONAL DISTRIBUTION

"Distribution and Changing Issuer Needs"

Terrence Connelly
Vice President of Corporate Finance
Salomon Brothers Inc

The effects of deregulation and related trends on issuer activity is the core of what is happening in our business. The impact of deregulation on the structure and management of investment banks can be viewed in a general sense first. No one in our business is unfamiliar with the entry of the Japanese universal banks and the competition we face from, for example, Nomura Securities. Niche strategies have also developed as participants in our industry have defined areas such as high yield securities, focused on technology and the financing of financial institutions and the like.

Intensified price competition almost goes without saying in a deregulated environment, and it is very much a part of life since deregulation in the securities industry. The unbundling and rebundling of financial products and services is very much part of what I will outline today. I encourage you to think about how our industry has taken the products that we

are used to selling and found new ways to separate their constituent elements or bring them together.

This phenomena of unbundling and rebundling is at the core of specific types of issuer related developments. To some degree, our industry resembles an airline with the type of price competition that has come to the deregulated airline industry especially in the last two years. We are familiar with airline unbundling -- think of People Express and the unbundling of the cost of baggage handling as well as unbundling of meals and drinks.

You might think that this is stretching things a bit but if you look at the airline advertisements in the financial and other pages of our morning newspaper, we can recognize how our own industry is beginning to market this way. Perhaps a quick look at our own advertising, 20% off, how to save money on financing, begins to suggest that the patterns between our industry and the airlines are not that dissimilar. As we stretch this point further, the frequent flyer program resembles our industry coming to the point where we are talking about frequent funding programs.

I want to talk about five themes in detail. They are Innovation, Globalization, Securitization, Deequitization (the retirement of equity) and Concentration, which is resulting from the most important action of deregulation in the investment banking business -- Rule 415.

First, the innovation theme really links very closely with what we are discussing about bundling and unbundling. Think back to 1979 and consider the action of the Federal Reserve in October of that year, deregulating to a certain extent the price or the cost of money, interest rate controls, the management of interest rates and the fundamental changes affecting both investors and issuers. Problems for investors were created in terms of investment risks with the volatility introduced into the market. Problems for issuers also resulted, from high coupon debt on the balance sheet. The response of our industry was a classic unbundling of principal and interest by way of the zero coupon issues which led in turn in the government market to CATs, TIGRs and the beginning of what can be summarized as the Acronym War.

Since the 1980's began, a series of new products have developed, all of which can be considered examples of unbundling along the lines of zero coupon instruments, or rebundling, such as the matching of a swap with euro financing. A whole series of new products was introduced this past year. In the domestic market, we have witnessed the collateralization or the securitization phenomena -- the pass through of assets such as automobile receivables, commercial real estate, etc. to another group of investors. In the tax-exempt market, the entry of zero coupon capital appreciation bonds, put option

securities, adjustable rate securities, are all examples of innovation spurred on by deregulation outside of our industry and in the international markets.

Globalization, indeed, is another major theme which I will touch on only lightly. With the removal of the U.S. withholding tax, the export of innovation accelerated as other major countries in the financial world -- Japan, West Germany, Switzerland, and the United Kingdom -- liberalize their financial markets. This year has seen the first zeros, the duel currency bonds and euro yen bonds introduced in the international capital markets. We have clearly exported deregulation and innovation, and we expect this to continue.

In the past year, U.S. corporations raised $39 billion off shore, twice the volume of 1984 and half the U.S. market volume, with new issue activity in international finance reaching over $165 billion. Accelerating this trend is the relationship between the international market and the growth in particular of the swap market, which is estimated to have grown in excess of $180 billion through the first ten months of 1985. Accurate data for 1985 will suggest the size of that market to exceed over $200 billion.

Securitization is the third major development in the marketplace so far as issuer activity is concerned. Twenty-one percent of the mortgages outstanding and 45 percent of the new residential mortgages are securitized today. Commercial real estate securitization originated in 1984; grew in 1985. The underlying market continues to grow dramatically with $73 billion of new advances in the 1983-1985 period, thus expanding the potential for securitization of the commercial product-line. Last year also witnessed a resurgence of securitization of real estate equity financing, with $4 billion of new issues.

While the real estate equity marketplace shows signs of renewed strength, we also have deequitization. In 1984 and 1985, issuers raised virtually as much for financing mergers & acquisitions, leveraged buyouts (LBO's) and stock repurchases as for new physical or financial assets. The M&A, LBO, and stock repurchase activity -- which is, in part, a response to the threat of unfriendly takeovers -- can be traced to acts of deregulation at the State and Federal levels. In turn, issuers have retired $220 billion of equity in the last two years, virtually 10% of all corporate stock outstanding.

The last major theme for consideration is perhaps the most important for our industry -- concentration. This phenomenon is best addressed not only through our focus on lead managers' market shares, but also by understanding what's happening underneath the statistics. Before Rule 415, between 75-80% of new issues of debt was lead-managed by the top six firms. To see a move to 80-90% in that marketplace after Rule 415 is really not that dramatic; yet there is drama beneath those

statistics. First, we need to look at what is happening with respect to the syndicate process. The fundamental fact is that 45 cents of every dollar of new money raised in the U.S. public taxable market since Rule 415 has been raised without a syndicate. These funds were raised by one or two or a few managers buying the whole issue. The number in this particular case jumped up to about 20% shortly after Rule 415 and has been growing roughly at the rate of one-half percent a month, and has now reached 45 cents on the dollar.

Our organizational structure is keyed to our compensation structure and most of our existing profit center allocation systems are clearly obsolete. They pre-date the effects of deregulation in our industry and the integration and product matrices that we are marketing to issuers. Who gets the credit in terms of these obsolete allocation systems for financing, say, for a U.S. company in the Midwest, linked to a cross currency interest rate swap? More importantly, when do they get that credit, because when is that revenue received?

These are the kinds of questions that we have to think anew in terms of the internal structures of our organizations. We have to find ways to integrate our sales, trading, finance and research organizations in ways that mirror the bundling and unbundling of our product mix. Our bonus structures and incentive structures are trapped in a general sense in past concepts that no longer reflect the way profits are made in the industry. The firms that have been successful in a deregulated environment have been successful in spite of, not because of, their internal accounting structures. No one has a good answer to these questions. Without such answers, however, we won't be able to progress into the era that continues to threaten as well as reward us.

"Distribution and Changing Institutional Investor Needs"

Richard S. Falk
Capital Markets, PaineWebber Incorporated

Prior to Mayday (May 1, 1975), the institutional equity business was relationship oriented with research and other information flows attracting institutional customers. Since Mayday, the institutional securities business has shifted more towards a transactional mode and securities firms found it necessary to develop trading expertise supported by large sums of capital. The traditional bond trading houses also moved into the institutional equity business. As institutional commission rates plunged, trading became an important part of investment strategy. Volume grew rapidly (five times in ten years) and the business became more concentrated. This increased volume helped to offset the effects of a sharp decline in rates.

During the past 10 years, there has been tremendous pressure on the financial services industry and its clients due to economic conditions. The inflation in the late 1970s and early 1980s reduced the real rates of return on investment. At the same time, the cost of servicing financial clients grew dramatically.

Disinflation, while improving the environment for investing, has brought with it a different set of problems. One result has been increased volatility of financial instruments, particularly when viewed globally as nations and companies have struggled to adapt to rapidly changing and adverse economic conditions. This, in turn, has created inefficiencies in valuation of various instruments and sectors. Arbitrage in different instruments has allowed many to capitalize on these inefficiencies. This trend has meant even more trading and transactions crossing international boundaries.

Technology has been a major factor in our industry. In 1969, many regional customers did not have same-day delivery of the Wall Street Journal. Today, large amounts of information can be processed and distributed almost instantly and provided to a larger group at lower cost. Today's money managers are getting more data than ever, and on a split-second basis. This allows them to make more decisions more quickly. This, in turn, leads to greater transactions and greater volatility.

These trends have put pressure on trading and liquidity and created a hunger for new products and strategies. Many of these revolve around trading -- options, futures, and related strategies and arbitrages. Many firms have more computers, programmers, and systems in the trading department than in the research department.

Foreign securities are not a new product, but investing in them is a new strategy for U.S. money managers. Several firms are building up their international research capabilities to rival their domestic efforts.

All of these trends have tended to further institutionalize the marketplace. Individuals have responded by moving increasing amounts of their investment to packaged products lately, especially mutual funds. The distribution of these products has become an important service provided by the brokerage community.

One recent new trend is the creation of converters. They offer access to a variety of investment management and measurement products, and sometimes offer cash rebates to plan sponsors in order to help reduce costs. This has caused a conflict between the growing appetite for liquidity in the form of traditional block trading, OTC market-making, etc. and the siphoning off of the means to compensate for these capital

intensive services. One result of this may be increased dealerization of the marketplace over the next five years.

In summarizing the needs of today's institutional clients, they are: (1) liquidity; (2) new products and strategies; (3) instant communication of research and investment strategy information; and (4) access to global markets and product distribution.

"Distribution and Globalization"

E. Daniel Morris
Morgan Stanley & Co. Incorporated

A global market is defined as a market without national boundaries where prices are based upon supply and demand from around the world and not predominantly from a single market. In today's markets, major currencies and precious metals meet these criteria. The Eurodollar markets come close to this definition, but are in a somewhat different category because of the linkage with the U.S. capital markets. There are, of course, many other national markets where there is worldwide investment participation but where prices are generally determined by domestic considerations. U.S. government securities and equities are examples, and should be referred to as global investment markets.

Despite continuing segmentation of capital markets, the investment of capital is becoming increasingly global. In recent years, American institutions have begun expanding their overseas investment. This is the beginning of what will become a substantial shift in the composition of U.S. institutional investment. A similar trend is underway in Japan where domestic institutions, long confined to the domestic market, have begun to invest sizeable amounts overseas.

The point of this distinction between markets and investments is that, as securities firms, we deal in national markets. However, our clients, the larger issuing entities and investing institutions, clearly are moving toward global strategies.

Deregulation is now proceeding very quickly in London and Tokyo, the two largest overseas market centers. The U.K. government and the City are responding by breaking down the domestic boundaries which have existed between securities dealing, broking and merchant banking. The Gilts market, which accounts for about 75% of volume on the London Stock Exchange, is also being opened to foreign dealers. London is also putting into place an entirely new system of self regulatory organizations (SROs), each dealing with specific sectors of the market. The SROs will operate under a legislated Securities and Investments Board.

Another driving force toward globalization is the privatization taking place overseas. The experience of the Tory government in the U.K. in privatizing publicly held companies is making available a new and relatively large supply of high quality securities for domestic investors, as well as for foreign investors. This trend toward privatization is also occurring under the present socialist government in France. We are seeing similar moves in Italy, Singapore and elsewhere.

Another force driving globalization of investment is technology. There have been major advances in telecommunications systems, management information systems, the availability of real-time trading and settlement systems which have made the markets more efficient. This has also allowed the development of a number of sophisticated new financing tools. These include interest rate swaps, currency swaps, and interest rate futures together with various hedging and arbitrage systems. These have helped link capital markets for issuers as well as investors.

The globalization of investment is also being driven by increasing competition in the management and control of financial assets. In portfolio management, for example, performance is more often being measured in global terms, which takes into account the relative valuation of equities in different markets as well as currency fluctuations. Managers therefore must compare domestic companies with foreign companies.

In Japan, institutional forces for deregulation appear to be even stronger. In the Japanese equity market, domestic institutions are the dominant holders of equity securities. The institutional structure of Japan's financial markets is now undergoing substantial change. Japan's new role as the world's largest capital exporter is one factor bringing about this change.

Examples of new markets in Japan include sales of dollar CDs and CP, mortgage securities, cross currency asset and liability swap products, and yen bond futures. These kinds of market activities were not possible in Japan a few years ago.

There will be continued growth in arbitrage between credits and between markets. Arbitrage and hedging techniques will continue to proliferate. This will facilitate the origination and distribution of issues globally. Last year, over three quarters of the issues in the Euromarkets were linked to swaps and hedging instruments.

Better technology will develop, bringing forth better information flows within and between markets. We are still in the very early stages of adapting computer systems and telecommunications to the markets. As an industry, we will have to continue to make relatively large expenditures on technology over the next several years.

A relatively small number of institutions will be successful on a truly global scale, because many participants will be unable to meet the needs of an ever more sophisticated, inter-related and institutionalized marketplace. However, there will be many successful firms who will not try to be everything to everybody and will specialize in their areas of greatest strength.

"Distribution Strategies: The Key To Serving A Changing Marketplace"

C. B. Rogers, Jr.
IBM Corporation

The information processing and securities industry have many parallels. Both are extremely competitive. Both serve an expanding customer base and both are handling a dramatic surge in volume. Both industries are keenly affected by the rising cost of people-intensive services. We are both driven by technological innovation. We increasingly exploit the benefits of communications, automation and information processing as an integral part of our business: to control costs, increase productivity and achieve profitability. Thus, operationally, we're both trying to reduce costs, manage complexity and optimize field performance. Strategically, we are both developing new products, services and distribution channels to give us a competitive advantage.

Over the past years, technology has extended the power of information systems to the fingertips of millions of users at a lower cost than ever. We are beginning a phase where the new uses of information are changing the fundamental way in which people live and work. That begins to have broad implications for distribution strategies. To illustrate that point, let's consider a few trends.

Artificial Intelligence seeks to emulate the leaps of logic performed by the human brain. We are already beginning to see software that borrows expert system techniques to recreate human reasoning and make it useable in workstations and personal computers.

Software itself will become easier and more powerful to use as developments in reduced instruction set technology and natural language processing begin to show real promise.

Before I suggest what these changes may mean to your distribution strategies, let me touch briefly on some of the lessons we have learned as we have approached changes in technology and the marketplace.

First, it is possible, although challenging, to add additional channels of distribution, retain existing customers and acquire new ones -- all at the same time. Second, despite overlaps in our coverage strategies, multiple channels of distribution increase overall business. Third, customers like having choice of channels commensurate with the level of support required. Fourth, as technology allows us to enhance and supplement our distribution channels with other methods, we have to ensure that these new customer interfaces represent us with the same quality and performance we expect from our people. Fifth, there is no perfect model for everyone.

We try, like you, to create value in everything we do: in the way we design, develop, package and deliver our products; and in the way we approach our markets on a day-to-day basis through cost reduction, better technology, choices, improved methods of distribution and higher quality.

In the end, it is an organization's ability to do this year in and year out that sets it apart from its competition, and in the final analysis, that's what distribution strategies are all about.

Information is the basic building block of the modern enterprise. It should not be viewed as simply an expense item because, when used properly, it becomes a major resource for revenue production. Information systems plans must be in concert with strategic goals; the two must be linked together for optimal results.

Frequently, chief executives tell me they are frustrated by the inflexibility of their information systems. When a change is made in their business or a new product is added, they are told it will take months to accommodate their plans. I believe much of this can be avoided if the top person in your information systems department is made a member of your strategy development team.

RETAIL DISTRIBUTION

"Meeting the Changing Needs of Retail Customers Through the Distribution Mechanism"

John L. Steffens
Merrill Lynch Consumer Markets

Distribution hinges on one thing -- satisfied customers. The customer is king. The reason we distribute the way we do is because the customer said that's what he or she wants by paying for it. If the product doesn't fulfill a need and provide value to the customer then the distribution doesn't matter. The point is that the customer is driving our strategy, our product development and our distribution. If

you don't run your business that way I suggest you look again because the customer revolution is not about to go away.

Merrill looks at the customer in terms of lifestyles and needs. The six basic financial service needs of a customer during his lifestyle look like this:

- o saving and cash management
- o investment
- o tax minimization
- o protection
- o finance
- o housing

I should note that the customer here is upscale (a household with $100,000 in income); the customer that nearly everyone in the financial industry is trying to attract.

Lifestyles of each market segment come into play. We feel it is important to know when your customers' needs are the strongest. For instance, a young married couple starts out thinking about financing, saving and cash management and less about tax minimization and retirement. Realizing this, we meet customers' needs and segment our customers. We carefully identified our target client groups with the intention of developing broader and stronger relationships with our clients.

As we segmented, we defined needs and integrated solutions with specially designed products and services. All along the way we made sure there was quality in everything we offered and the way we offered it. We knew the battle of the future would be fought for quality. And we all know what quality is. As Winston Churchill said, "I am easily satisfied with the very best."

For example, our IRA account has more than fifty products that can be put in it; products from the speculative to the very conservative, like bank insured CD's. Similarly, the TIGR and LYON products answered specific needs of specific segments.

We defined needs and integrated solutions with specially designed products and services. As you can see, segmentation is the first step in our distribution development; in some cases Merrill has even developed sub-segments. The basic groupings are capital markets and consumer markets.

On the consumer markets side, we segment the affluent or established investor, our traditional customer. We also have a sub-segment called the emerging investor. The consumer market utilizes our branch system of 10,000 financial consultants in 500 offices around the country. While some have said this system is too expensive, we feel this system gives us an advantage. Personal contact is of real value when helping an individual with his financial portfolio.

If we do our job and define the markets, needs and products, then we have added value for the customer. And he will pay for it.

"Distributing Investment Products in an Insurance Company Environment"

Stephen L. Brown
John Hancock Mutual Life Insurance Co.

John Hancock and other insurance companies are becoming more investment oriented and competing directly with securities brokers and other purveyors of investment products. In approaching the distribution of investment products, the insurance industry faces many of the same issues as securities firms. These include holding down the cost of distribution, maximizing the efforts of the existing sales force, developing synergy among diverse product lines, making effective use of technology and experimenting with new methods of distribution.

John Hancock's 10,000-member field force remains its dominant distribution system, and we have no intention of doing anything that might harm this strength. The role of John Hancock's traditional distribution system is changing for several reasons, including the need to control costs. One of our key strategies has been the addition of new financial services, including investment products, to give our agents additional sources of income while spreading costs over more products.

Last year, John Hancock's agents earned an average of about 25 percent of their income from mutual funds and other supplementary products, compared with zero percent less than two decades ago. We have been very successful in marketing fixed-income bond funds and other conservative investment products through our agency force, reflecting the middle-income, middle-America marketplace where we are strongest. About 7,400 of our agents are now NASD registered to sell investment products.

We will continue to provide our agents with new financial products to enhance their competitiveness and broaden our cost base. These include mutual funds, as well as tax shelters and other products manufactured by Tucker Anthony and others.

Recently, we joint-ventured a John Hancock real estate partnership with Merrill Lynch in which we manufactured the product and did much of the selling, supplemented by our agency force. Currently, we are putting together a network of regional brokerage firms for additional distribution of our mutual funds.

Variable life products are another central element in our distribution strategies. These products are a hybrid between ordinary life insurance and a security. The initial amount of insurance is guaranteed for life, but above that minimum the insurance amount and cash value depend on the performance of separate accounts chosen by the customer.

We want Tucker Anthony to be a good investment, and they are on schedule in this regard. Tucker Anthony also represents an important entry into upper-income markets, complementing John Hancock's existing strength in serving middle-income customers.

John Hancock also has a fledgling direct response marketing program. This program has been in effect for about two years, and is focused on the sale of certain insurance products by direct mail. These products have expense loads and size limitations that would make them uneconomic for our agents to sell. So far, the results are promising.

In conclusion, we are adding new products, searching for new customers, and broadening our distribution channels, while continuing to emphasize our agency field force. I believe we are well positioned for the no-holds-barred competition in the future financial services industry.

SPECIFIC RETAIL DISTRIBUTION STRATEGIES

"Packaged Products as a Distribution Strategy"

John C. Merritt
Van Kampen Merritt Inc.

First, let's look at the packaged product industry with a few numbers. In 1979, the total amount of Unit Investment Trusts (UITs) sold was $3.1 billion. The mutual fund industry managed to sell $6.8 billion of products in 1979. In 1983 the UIT industry sold $14.8 billion while the mutual fund industry expanded to over $40.3 billion. In 1985, the UIT area grew to $15.3 billion while the mutual fund industry raised $110.5 billion.

Let's take a look at why this product has become popular. The customer benefits because the packaging of a tax-exempt UIT allows the customer to acquire bonds which, in many instances, would be unavailable in a rising market because they would go to institutions. The sponsor is capable of buying at the institutional level, in large enough quantity so that he can assure that the individual UIT holder gets his fair share of the product.

Mutual funds afford the same opportunity: they afford professional management for many products. Today, particular efforts can be seen in the growth of U.S. government funds where the packaged product affords a better rate of return then the individual product would if purchased individually.

What type of distribution avenues do most packagers use? Basically, there are three primary types that are used in distributing our product line: direct selling (generally no-load funds), the utilization of selected broker-dealers and a combination of both.

Van Kampen Merritt made a major decision to be a rather unique distributor in the manufacturing chain. Rather than compete for or distribute directly to the individual, we made a decision to be a partner in developing products and distributing it through the NASD network. We view ourselves as a true product manufacturer. Not only are we developing products in the UIT and mutual fund area but we are also expanding in the insurance product line.

One of the biggest questions upper management has to analytically look at is "should we use an outside vendor to distribute the product or should we develop it internally?" In the case of the UIT, approximately a year and a half ago there were probably four to five sponsors. Today, there are over 17 different types of sponsors. This particular industry is probably reaching a saturation point and some of the sponsors will probably not survive during the next two to three years.

One should make sure he analyzes his own firm's distribution capabilities and where the cross over in economies of scales are. And, I think when you look at the UIT industry, if you are doing a national UIT, your economies of scale probably approach $20 million before you are really economically on the plus side over the life of the product. Upper management must also look at questions regarding the number of products to distribute, marketing and capital concentration.

Upper management is increasingly starting to look at product dissemination at the different branch levels. They are also starting to guide different types of products to different types of geographical regions throughout the U.S. As we turn to these types of questions, which we all face in upper management, we have to look to the future and say "where are we going?" One of these areas will be packaged products. We feel strongly that by the early 1990's, 90-95% of all your products will be sold through a packaged medium of some kind.

"Discounting as a Distribution Strategy"

Edward J. McLeod
Fidelity Brokerage Services, Inc.

This presentation is fairly specific regarding Fidelity Brokerage's experience with discounting as a marketing tool. Discounting has already had a reasonably significant impact on the marketplace. Even allowing for some weakness in the underlying data, we conclude that the discounters' market share of retail commissions has grown to about 8%-9% and we are looking at reasonably steady growth over the next four-year period.

Discount brokers in 1984 are estimated to have captured 20% of the retail trades executed. More importantly, 40% of all retail new accounts are being opened by discount brokers.

About 15% of commission dollars generated by the often-referred to "upscale client," is being collected by discounters. "Upscale" is usually defined as a household with more than $45,000 annual income. A little more than 20% of the commissions generated by the "young upscale" clients is going to discounters. Discounters have to: (1) offer the right price; (2) develop, use, and enhance the most efficient and effective delivery systems; (3) recognize that price alone is not enough to attract customers -- a value-added service of acceptable quality is required; and (4) control and reduce operating expenses vigorously. We are convinced that our customer base calls for more than one delivery mechanism.

Our experience with local branches does not appear to be any different than most other firms. We are able to attract some customers to our firm that we would not attract without a local presence; and some of our customers specifically prefer a local, or in-person, relationship. As we choose sites for new branches, we need adequate and accurate demographics to ensure a large enough potential market in order to make the branch worthwhile. While trying to be sensitive to customers who prefer a local presence, we have to ensure that those branches are sufficiently profitable, or potentially profitable, to justify the expense of local branching.

Fidelity has attempted to define, by trade volume and commission revenues generated, which levels of client we economically service in a branch environment. Customers are identified into categories of "platinum," "gold," and "silver." The "platinum" customer is highly profitable and receives as much immediate and special attention as possible. The "gold" category client is earmarked for directed sales and marketing efforts through the branch manager because these clients, in terms of the volume of business they do, are

upwardly mobile from an unprofitable or marginally profitable level to a satisfactorily profitable level. The other possibility is at the "gold" level; a client who was in the highly profitable "platinum" category but slipped downward in terms of the business generated. We try and implement special sales emphasis from the manager and his staff to encourage a return to the most profitable level.

The last category is the "silver" level. This covers clients who do very little business with us, and given the expense of a branch transaction, cannot be profitable to us. Collectively, however, these customers represent a substantial gross income potential, which should be convertible to net income. We provide this level of client with an "800" telephone number through which he or she can transact business, receive a high level of professional transaction service, and at the same time, enable us to earn a profit through the economies of scale possible in a centralized, high-tech environment.

In our usage of telecommunications, we are usually referring to the use of "800" telephone numbers. We generally have our initial customer contact, generated through our advertising, handled centrally and then forwarded to the appropriate branch as a lead referral. We are completing a system which will give all our customers a centralized "800" number to use for quotes, and we have the capability for subsequent order-taking on the phone, or a direct transfer to the appropriate branch, depending on the circumstances.

If we are to be successful, we must think within a broad framework that encompasses the customer we serve; the product we offer; and the delivery systems we use. We have to be flexible in trying to mix-and-match customers, products, and delivery systems. Finally, we must maintain a highly creative approach to the way we function within the marketplace.

THE ROLE OF TECHNOLOGY IN DISTRIBUTION

"Technology, Markets, and Distribution"

William M. Saubert, Coopers & Lybrand

The securities industry's attitude toward technology is very revealing. Brokers may be strong on high-tech stocks from time to time, but when it comes to bringing modern communications technology into their own shops, "short interest" runs high. When you compare securities individuals with their counterparts in other financial services, the securities industry is always less optimistic about, less committed to, and less interested in exploiting the benefits of technology.

Brokers say they use technology to keep up with the Joneses. They expect to gain a bit of more strategic help from technology. This is a lot less than that projected by bankers, insurance companies, etc. Technology has fairly well saturated the operational functions across the financial services industry. Almost everyone uses it for distribution and sales. There is a strong drop-off when it comes to using technology to gain competitive advantage. Only one in four brokers uses return on investment or return on asset guidelines to judge technology investments being made either to increase the company's efficiency or to lower the cost of operations. Almost all bankers do. When asked how important technology is to them, brokers rated lower than banks, insurance companies, etc.

Brokers want technology to keep up with the Joneses. They do not evaluate how dollars are spent. They do not find that much use for technology for day-to-day improvements, strategic direction, or a new generation of enhancements. Brokers are by far the most bullish on people. Hardly any see machines taking over for traders and RRs.

It won't do to simply evaluate the technology function as a cost center and compare it to a peer's cost center. That doesn't change your strategic thinking about information processing, which is what you have to do.

Expert systems can quickly sort through high volumes of transactions in many financial instruments and present the best trading situations to the broker. After all, the greatest complicator in the securities environment is the mass and velocity of data that markets generate.

Our survey found that one in five of the executives interviewed had experienced unauthorized access to their computers or databases in the past five years. That's a scary figure. Thus, you should take any steps necessary to protect the integrity of your systems.

Summaries Prepared By:

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VOLUME

	JANUARY 1986	YEAR-TO-DATE 1986	JANUARY 1985	YEAR-TO-DATE 1985	% CHAN. Y-T-D. 1986-1985
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	133.4	133.4	121.5	121.5	9.8%
AMEX (MILS.)	11.1	11.1	9.1	9.1	22.0%
NASDAQ (MILS.)*	107.6	107.6	84.1	84.1	30.3%
REGIONAL EXCHANGE (MILS.)*	N/A	N/A	19.3	19.3	N/A
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$105,010	$105,010	$89,235	$89,235	17.7%
AMEX (MILS.)	3,058	3,058	1,930	1,930	58.4%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	8,269	8,269	7,484	7,484	10.5%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	18,589	18,589	17,670	17,670	5.2%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	49.5%	49.5%	51.3%	51.3%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	15,226	15,226	13,948	13,948	9.2%
AMEX OPTIONS	5,573	5,573	3,351	3,351	66.3%
COMMODITY	16,279	16,279	13,253	13,253	22.8%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

YIELDS

(MONTHLY AVERAGES)

	JANUARY 1986	JANUARY 1985	BASIS POINT CHG 1986-1985
BOND BUYER INDEX (20 BOND)	8.08%	9.51%	(143)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	10.05	12.08	(203)
Baa CORPORATE	11.44	13.26	(182)
RATIO Aaa CORPS. TO Baa CORPS.	0.88	0.91	(3)
MUNICIPAL BOND YIELDS (MOODY'S)	8.08	9.51	(143)

PRICES

(END OF MONTH)

	FEBRUARY 1986	FEBRUARY 1985	% CHAN. Y-T-D 1986-1985
DOW JONES INDUSTRIALS	1709.06	1284.01	33.10%
STANDARD & POOR'S 500	226.92	181.18	25.25%
NYSE COMPOSITE	130.74	104.93	24.60%
AMEX MARKET VALUE INDEX	257.35	227.43	13.16%
VALUE LINE COMPOSITE	229.56	197.66	16.14%
NASDAQ COMPOSITE	359.53	284.17	26.52%

UNDERWRITING

	FIRST QUARTER 1986	FIRST QUARTER 1985	% Change 1986-1985
CORPORATE FINANCING (Gross New Issues - Millions)			
TOTAL	12,735	5,952	114.0%
Common Stock	1,915	636	201.1%
# of Common Stock Issues	43	32	34.4%
Preferred Stock	645	265	143.4%
# of Preferred Stock Issues	9	5	80.0%
Corporate Debt	10,175	5,051	101.4%
# of Corporate Debt Issues	115	65	76.9%
	FEBRUARY 1986	FEBRUARY 1985	% Change 1986-1985
MUNICIPAL FINANCING			
TOTAL (Bonds Only)	4,535	12,837	-64.7%
Notes	N/A	N/A	N/A
Bonds	N/A	N/A	N/A

MARGIN DEBT

	JANUARY 1986	JANUARY 1985	% CHANGE 1986-1985
MARGIN DEBT OUTSTANDING ($MILS)	26,810	22,090	21.4%
NET CHANGE IN MARGIN DEBT ($MILS)	4,720	(780)	-705.1%
% OF ACCOUNTS WITH EQUITY UNDER 40%	10%	10%	-----

FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
(MILLIONS OF DOLLARS)

	Third Quarter 1985	Yr. -To-Date 1985	Third Quarter 1984	Yr. -To-Date 1984	% Change 3rd Q. 1985 3rd Q. 1984	Yr. -To-Date % Change 1985 - 1984
REVENUE						
SECURITIES COMMISSION INCOME	$1,865	$6,012	$1,766	$5,387	5.6%	11.6%
TRADING PROFITS	2,100	6,913	2,005	5,134	4.7	34.7
UNDERWRITING	1,013	2,720	659	1,836	53.7	48.1
TOTAL REVENUE	8,815	27,024	8,324	22,698	5.9	19.1
TOTAL EXPENSES	8,144	24,392	7,632	21,594	6.7	13.0
NET INCOME BEFORE TAXES	671	2,632	692	1,104	(3.0)	138.4
PERCENT OF FIRMS SHOWING LOSS	32.4%	NA	30.9%	NA	---	---

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
Economic Report of the President	Annual report prepared by the Council of Economic Advisers examining the state of the economy and future outlook. This year's report details inflation and disinflation in the macroeconomy and also focuses on the developing countries and world trade. Comprehensive statistical tables relating to income, employment and production.	Superintendent of Documents U.S. Government Printing Office Washington, DC 20402
Corporate Finance 1985: The Red Hot Year	Domestic financing volume soared to a record $138.3 billion in 1985, compared with $82.4 billion in 1984. IDD's annual issue details corporate finance for year, with ranking of book manager and co-manager by type of issue. Also includes listings of 25 largest debt and equity deals.	Investment Dealers' Digest 1/13/86
"Financial services--who owns the future?"	While brokers are an expensive way to sell products, the amount of new capital brought in by direct marketing techniques is but a fraction of the capital brought in by brokers in direct contact with customers. Article concludes that big brokers will continue to own the largest piece of the financial services market, but not necessarily the most profitable.	Forbes 2/24/86
"Mutual Funds: Assets Soar, Performance Doesn't"	In 1985, investors poured $114.3 billion into stock, bond and income funds, dwarfing 1984's record inflow of $45.9 billion. However, while some funds outperformed the averages, most did not. Special section reviews performance of various types of funds based on Lipper gauge, with emphasis on fourth-quarter.	Barron's 2/17/86
Innovation in the International Capital Markets	Four-part, specially sponsored supplement reviewing deregulation in certain foreign markets and the avenues that have been opened for international capital raisers. In addition, the practical mechanics of some of the new instruments in international financing are covered, including swaps.	Euromoney Supplement January 1986

The Liquidity of Alternative Money Centers: A Comparison of the NYSE, Amex, and NASDAQ National Market System	Two NYU professors measure liquidity in the three markets via a "market efficiency coefficient", which relates short-period to longer-period volatility. Concludes: Design of the market has a substantial impact on liquidity. As currently structured, exchange markets are more liquid than the NASDAQ/NMS system.	American Stock Exchange
"Glory Days for IRAs"	Special report detailing the many choices available to individuals opening, adding to, and shifting IRA accounts.	Money March 1986
"The Business Transfer Tax--A VAT By Any Other Name"	Article describes BTT and tax reform proposals introduced by Senator Roth, which would impose a tax on the value added at each level of production through a subtraction-method VAT. The mechanics, impact, trade aspects and prospects of the BTT are reviewed. Of note: the BTT would fall significantly and disproportionately on service companies and other businesses that otherwise would benefit from the proposed rate reduction of tax reform.	Tax Notes 2/24/86
Taxpayer Behavior and the Distribution of the 1982 Tax Cut	Using 1982 data, paper examines the effect of the 1981 Tax Act on the responsiveness of taxpayers to tax rates and incentives, foregone revenue, and the distribution of the tax burden. Concludes: there was a significant behavioral response to the rate reductions of 1982. On average, about half of the revenue which would have been lost due to rate reductions was recouped. The data also suggest that an actual increase in revenue occurred for top bracket taxpayers, making it likely that the revenue maximizing top marginal rate is below the 70% which existed prior to 1982.	Working Paper No. 1760 National Bureau of Economic Research 1050 Massachusetts Avenue Cambridge, MA 02138

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